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In the Supreme Court of the United States

OCTOBER TERM, 1943

No. 63

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

S. B. HEININGER

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 25–34) is reported in 47 B. T. A. 95. The opinion of the Circuit Court of Appeals (R. 46–49) is reported in 133 F. (2d) 567.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 15, 1943 (R. 50). The petition for a writ of certiorari was filed on May 14, 1943, and was granted on June 14, 1943. The

jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the taxpayer, who was engaged in the business of making and supplying artificial dentures by mail order, can deduct as ordinary and necessary business expenses under Section 23 (a) of the Revenue Acts of 1936 and 1938 the sums spent by him in unsuccessfully resisting the issuance and enforcement of a fraud order by the Postmaster General relating to such business.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 22–24.

STATEMENT

The pertinent facts, as stipulated by the parties and as found by the Board, are as follows (R. 25–29):

The taxpayer was a licensed dentist in Illinois during the years 1926 to 1939. His principal work since 1932 was the making of artificial dentures for customers who did not personally visit his office. Before such dentures were made for a customer, the taxpayer required from and there was forwarded to him from such customer a payment of $2 generally designated as a "deposit." The dentures, when completed, were mailed or shipped, C. O. D., for the amount of the charges

less the $2 "deposit". (R. 25.) The gross receipts from this business, in 1937, were $287,582.82, and for 1938 they amounted to $150,168.27 (R. 29).

On September 22, 1937, a citation was issued by the Solicitor of the Post Office Department, charging that the taxpayer was engaged in conducting a scheme for obtaining funds through the mails by means of false and fraudulent practices, in violation of Section 3929 of the Revised Statutes. Shortly thereafter the taxpayer appeared before the Post Office Department, answered these charges, and employed attorneys to render legal services in resisting the issuance of a statutory "Fraud Order". (R. 27.)

On February 19, 1938, and after a hearing under the above-mentioned citation, the Postmaster General issued a "Fraud Order," forbidding the Postmaster at Chicago, Illinois, to pay any money orders drawn to the order of the taxpayer, and instructing the Postmaster to return all mail addressed to the taxpayer, to the senders, marked "Fraudulent." Thereafter, on February 25, 1938, the taxpayer filed suit in the District Court for the District of Columbia against James A. Farley, Postmaster General, and on that date the court entered an order directing the latter to hold all mail addressed to the taxpayer until the further order of the court. (R. 27.)

On June 6, 1938, the District Court granted the taxpayer a permanent injunction, restraining the Postmaster General from enforcing the

"Fraud Order" or otherwise proceeding in accordance with its terms. On appeal, the order of the District Court was reversed on April 17, 1939, and the case was remanded with instructions to dissolve the injunction and to dismiss the bill of complaint. The taxpayer's application for a writ of certiorari was denied in the October Term, 1939.[1] The taxpayer paid attorneys' fees and other legal expenses in connection with the above-mentioned proceedings amounting to $7,069.99 in 1937, and to $29,530.56 in 1938. (R. 27–28.)

The Commissioner refused to allow the taxpayer to take deductions for these sums, and the Board of Tax Appeals approved the Commissioner's determination on the ground that such expenditures did not constitute ordinary and necessary expenses of the taxpayer's business but were incurred in connection with illegal practices (R. 27, 31–34). The Circuit Court of Appeals reversed the decision of the Board of Tax Appeals (R. 46–50).

SUMMARY OF ARGUMENT

The legal expenses incurred by the taxpayer in unsuccessfully resisting the issuance and enforcement of a statutory fraud order by the Postmaster General are not deductible as "ordinary and necessary" expenses. Not only are deductions from

[1] That case is reported as *Farley* v. *Heininger*, 105 F. (2d) 79 (App. D. C.), certiorari denied, 308 U. S. 587.

gross income a matter of legislative grace to which the taxpayer must clearly establish his right, but the taxpayer also has the burden of overcoming the Commissioner's determination that the expenditures involved were not "ordinary and necessary" expenses.

This Court has construed the statute as embodying an objective test of what is "ordinary and necessary," requiring that expenses in order to be so described result from transactions "of common or frequent occurrence in the type of business involved." *Deputy* v. *du Pont,* 308 U. S. 488, 495; *Welch* v. *Helvering,* 290 U. S. 111, 114. The court below erroneously applied a subjective test, and interested itself only in whether these expenditures were "ordinary and necessary" in this particular taxpayer's scheme of things. The legal expenses in question were incurred as the direct result of taxpayer's participating in activities expressly prohibited by a federal statute. Activities of such nature cannot be said to be "of common and frequent occurrence" in the type of business in which the taxpayer was engaged; certainly in the practice of dentistry it is neither common nor frequent to make false and fraudulent representations through the use of the mails.

Decisions in numerous analogous cases, including *Textile Mills Corp.* v. *Commissioner,* 314 U. S. 326, support the view that implicit in the statute is the understanding that expenditures which, as

here, arise as the result of unlawful transactions or activities which are against public policy, are not deductible as "ordinary and necessary" expenses.

ARGUMENT

THE LEGAL EXPENSES INCURRED BY TAXPAYER IN UNSUCCESSFULLY RESISTING THE ISSUANCE AND ENFORCEMENT OF A STATUTORY FRAUD ORDER BY THE POSTMASTER GENERAL ARE NOT DEDUCTIBLE AS ORDINARY AND NECESSARY BUSINESS EXPENSES

1. In connection with his unsuccessful resistance of the issuance and enforcement of a statutory "Fraud Order" by the Postmaster General, the taxpayer incurred and paid various attorneys' fees and legal expenses which he seeks to deduct from gross income as "ordinary and necessary" business expenses under Section 23 (a) of the Revenue Acts of 1936 and 1938 (Appendix, *infra*, p. 22). At the very outset it should be borne in mind that, since deductions from gross income are a matter of legislative grace, the taxpayer has the burden of establishing his right to the deduction. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440; *White* v. *United States*, 305 U. S. 281, 292. And it is firmly settled that deductions or exemptions must be construed strictly against one claiming the benefit thereof. As stated in *Bank of Commerce* v. *Tennessee*, 161 U. S. 134, 146:

> There must be no doubt or ambiguity in the language used upon which the claim to

> the exemption is founded. It has been said that a well founded doubt is fatal to the claim; * * *

See, also, *United States* v. *Stewart*, 311 U. S. 60, 71. Furthermore, since the Commissioner here has ruled that the expenditures in question are not deductible, his ruling has the support of a presumption of correctness, and the taxpayer has the burden of proving it to be wrong (*Welch* v. *Helvering*, 290 U. S. 111, 115).

2. The question presented in the instant case can perhaps be most profitably explored against the background of this Court's decisions in *Welch* v. *Helvering*, *supra*, and *Deputy* v. *du Pont*, 308 U. S. 488, which consider in detail the principles to be applied in determining what constitutes an "ordinary and necessary" business expense.

In the *Welch* case the taxpayer had been an officer in a corporation which had been adjudged an involuntary bankrupt and relieved of its debts. Thereafter the taxpayer began to transact business on his own account and, in order to re-establish relations with customers whom he had known when acting for the corporation, undertook voluntarily to pay the corporate debts. The Commissioner of Internal Revenue ruled that such payments were not deductible from taxable income as ordinary and necessary expenses. This Court assumed that the expenses were "necessary," but sustained the Commissioner on the ground that they were

not "ordinary." Mr. Justice Cardozo said (pp. 114–115):

> Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, * * *. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

In *Deputy* v. *du Pont, supra,* the taxpayer, a large shareholder in the du Pont Company, made sales of his stock to the executive committee of the corporation in furtherance of the company's policy that the committee-men should have a financial interest in the corporation. The taxpayer borrowed the stock so sold and, in accordance with his agreement made with the lender, paid the latter a sum equivalent to the dividends on the borrowed stock, as well as taxes imposed upon the lender. In refusing to characterize such expenditures as "ordinary and necessary" business expenses this Court declared (p. 495):

> Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen but once in the taxpayer's lifetime. Cf. *Kornhauser*

> v. *United States, supra. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. Welch* v. *Helvering, supra,* 114. * * * [Italics supplied.]

It is apparent, therefore: *first,* that in considering whether a particular payment may be deducted as an "ordinary and necessary" business expense, the nature of that payment is to be determined by the character of the original transaction from which it stemmed; and *second,* that the test to be applied is objective, not subjective, and the expense is deductible only if the transaction from which it resulted is "of common or frequent occurrence in the type of business involved" (*Deputy* v. *du Pont, supra*). Thus, since it is the "origin and nature, and not the legal form, of the expense sought to be deducted, [which] determines the applicability of the words of § 23 (a)" (*Interstate Transit Lines* v. *Commissioner,* decided by this Court June 14, 1943, No. 552, last term) the mere fact that it may be ordinary and customary to defend law suits by employing counsel is not sufficient to permit deduction of legal expenses if the original activities out of which the suit in question arose are not "of common or frequent occurrence in the type of business involved." *Deputy* v. *du Pont, supra.* The application of the principle enunciated by this Court in *Deputy* v. *du Pont, supra,* as it pertains to the deductibility of legal expenses has been well stated

by the Circuit Court of Appeals for the Tenth Circuit in the recent case of *Hales-Mullaly* v. *Commissioner,* 131 F. (2d) 509, as follows (p. 511):

> Ordinarily an expenditure made for attorneys fees or other expenses in the defense of a suit or action against a taxpayer which is directly connected with or proximately resulted from his trade or business is deductible under section 23 (a). *Kornhauser* v. *United States,* 276 U. S. 145, 48 S. Ct. 219, 72 L. Ed. 505. But the naked fact that a voluntary expenditure was made for attorneys fees or other expenses in the course of legal proceedings or as the result of a compromise is not controlling within itself. The decisive test still is the character of the transaction which gives rise to the payment. *Colony Coal & Coke Corp.* v. *Commissioner of Int. Rev.,* 4 Cir., 52 F. 2d 923. It is whether the transaction occasioning the expenditure is normal, usual, or customary in the trade or business of the type in which the taxpayer is engaged. *Deputy* v. *du Pont, supra.*

It does not appear that the court below concerned itself with the principles above outlined. In holding the legal fees in question deductible on the ground that preservation of the taxpayer's business required such expenditures, the court seems completely to have ignored both the nature of the activities engaged in by taxpayer, which gave rise to the outlay, and the basic question

whether those activities were "ordinary and necessary." It erroneously applied a subjective test, whereas the proper test is objective. Here the expenses were incurred by the taxpayer as the direct result of his engaging in a scheme for obtaining money through the mails by means of false or fraudulent representations. The Postmaster General so found, and the Court of Appeals for the District of Columbia judicially determined that finding was fairly arrived at and was supported by substantial evidence. *Farley* v. *Heininger,* 105 F. (2d) 79 (App. D. C.), certiorari denied, 308 U. S. 587. Only through an excess of cynicism can it be said that an expense arising from fraudulent dealings was "ordinary"; that is, that the transaction which gave rise to it was "of common or frequent occurrence in the type of business" in which taxpayer was engaged. Certainly in the practice of dentistry it is not "ordinary" to make false and fraudulent representations through the use of the mails or otherwise. It is even more certain that such conduct is not "necessary." Cf. *Burroughs Bldg. Material Co.* v. *Commissioner,* 47 F. (2d) 178 (C. C. A. 2); *National Outdoor Advertising Bureau* v. *Helvering,* 89 F. (2d) 878 (C. C. A. 2); see also *Great Northern Ry. Co.* v. *Commissioner,* 40 F. (2d) 372 (C. C. A. 8), certiorari denied, 282 U. S. 855; *Tunnel R. R.* v. *Commissioner,* 61 F. (2d) 166 (C. C. A. 8), certiorari denied, 288 U. S. 604. The

court below thought that the expense was "necessary" because it preserved the life of the fraudulently operated business for a time, but the point is that the expense was not necessary unless it was necessary that the fraudulent practices be continued, and as Judge L. Hand has stated in a similar case, "the law will not recognize the necessity of engaging in illegal courses in the conduct of a business." *National Outdoor Advertising Bureau* v. *Helvering, supra*, at p. 881.

3. The correctness of the Government's position here is supported by a number of decisions denying the deduction of expenditures incurred as the result of activities which were illegal or contrary to public policy. These decisions, while not necessarily conclusive, are helpful in showing that such expenditures cannot be regarded as "ordinary and necessary" within the meaning of Section 23 (a).

Thus, it has been uniformly held that fines or penalties paid by the taxpayer as a consequence of statutory violations or legal expenses incurred in an unsuccessful defense of prosecution for such violations, are not deductible even though proximately connected with the taxpayer's business.[2]

[2] Where the legal proceedings fail to establish that the taxpayer has engaged in the illegal activities with which he was charged, it has been held that expenditures incurred in connection with those proceedings may be deducted. *Commissioner* v. *Continental Screen Co.*, 58 F. (2d) 625 (C. C. A. 6); *Commissioner* v. *People's-Pittsburgh Trust Co.*, 60 F. (2d) 187 (C. C. A. 3); *Citron-Byer Co.* v. *Commissioner*, 21 B. T. A. 308; *Headley* v. *Commissioner*, 37 B. T. A. 738;

Burroughs Bldg. Material Co. v. *Commissioner*, 47 F. (2d) 178 (C. C. A. 2) (fines and counsel fees incurred as the result of violation of state price-fixing laws); *Great Northern Ry. Co.* v. *Commissioner, supra*, and *Tunnel R. R.* v. *Commissioner, supra* (penalties paid as the result of violation of federal statute and regulations in operation of railroad). Cf. *Gould Paper Co.* v. *Commissioner*, 72 F. (2d) 698, 702 (C. C. A. 2) (counsel fees paid as result of negotiating a consent decree in a suit in equity and a plea of *nolo contendere* in a criminal prosecution by the United States under the

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G. C. M. 19976, 1938–1 Cum. Bull. 120; cf. *Pantages Theatre Co.* v. *Welch*, 71 F. (2d) 68 (C. C. A. 9).

In the court below the taxpayer built an argument on these cases, in conjunction with the principle of annual accounting (*Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359), to the effect that because the District Court decision enjoining the fraud order was still in effect at the close of the 1938 taxable year, the expenditures were at that time not against public policy and hence were deductible. This argument was not adopted by the court below. Its two major errors are: (1) the tax status of items in litigation is ordinarily determined by the final outcome of the litigation, not by its intermediate stages (see, for example, *United States* v. *Safety Car Heating Co.*, 297 U. S. 88); and (2) if the deduction were allowed in 1938 because the erroneous District Court decision was then in effect, an amount equivalent to the deduction would have to be added back to income in 1939 when the District Court decision was reversed (cf. *Lamont* v. *Commissioner*, 120 F. (2d) 996 (C. C. A. 8)), resulting in a patent distortion of income, which the Commissioner is empowered by section 41 (26 U. S. C. 41) to prevent in order to obtain a clear reflection of income (cf. *Brown* v. *Helvering*, 291 U. S. 193, 203; *Lucas* v. *American Code Co.*, 280 U. S. 445, 449).

anti-trust laws); *National Outdoor Advertising Bureau* v. *Helvering, supra* (legal fees spent in negotiating a consent decree to a suit in equity brought by the United States under the anti-trust laws); *United States* v. *Jaffray*, 97 F. (2d) 488 (C. C. A. 8), affirmed on other issues *sub nom. United States* v. *Bertelsen & Petersen Co.*, 306 U. S. 276 (penalty paid in civil action for negligent understatement of taxes); *Helvering* v. *Superior Wines and Liquors*, 134 F. (2d) 373 (C. C. A. 8) (legal fees and amounts paid in compromise of liabilities for violation of federal taxing statutes); *McDuffie* v. *United States*, 85 C. Cls. 212, 227 (legal fees spent in unsuccessfully defending a suit brought by the United States for cancellation of a lease on the grounds of fraud). See, also, *Bonnie Bros., Inc.* v. *Commissioner*, 15 B. T. A. 1231; *Levinstein* v. *Commissioner*, 19 B. T. A. 99; *Columbus Bread Co.* v. *Commissioner*, 4 B. T. A. 1126; *Achelis* v. *Commissioner*, 28 B. T. A. 244; *Sanitary Earthenware Specialty Co.* v. *Commissioner*, 19 B. T. A. 641; *Atlantic Terra Cotta Co.* v. *Commissioner*, 13 B. T. A. 1289; *Wolf Manufacturing Co.* v. *Commissioner*, 10 B. T. A. 1161; *Thompson* v. *Commissioner*, 21 B. T. A. 568, appeal dismissed, 62 F. (2d) 1082 (C. C. A. 8); *Lindheim* v. *Commissioner*, 2 B. T. A. 229.[3]

[3] In earlier cases, the Circuit Court of Appeals for the Seventh Circuit itself took a view in accord with these decisions. See *Standard Oil Co.* v. *Commissioner*, 129 F. (2d) 363 (C. C. A. 7), certiorari denied, 317 U. S. 688, rehearing

Similarly, considerations of public policy have been dominant in denying deductions on account of bribes paid by bootleggers, or expenses incurred in an illegal gambling enterprise, or payments made in response to commercial extortion (such as payments to racketeers). See *Maddas* v. *Commissioner*, 40 B. T. A. 572, affirmed, 114 F. (2d) 548 (C. C. A. 3); *Silberman* v. *Commissioner*, 44 B. T. A. 600; *Kelley-Dempsey & Co.* v. *Commissioner*, 31 B. T. A. 351; cf. *United States* v. *Sullivan*, 274 U. S. 259, 264. And deductions for "commissions" paid to persons for their use of personal influence in obtaining public contracts have likewise been denied. *Rugel* v. *Commissioner*, 127 F. (2d) 393 (C. C. A. 8); *Easton Trac-*

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denied June 7, 1943, in which it was held that the taxpayer could not deduct as an ordinary and necessary business expense sums paid the United States in compromise of a claim for the conversion of oil taken from the Teapot Dome. And in *Tinkoff* v. *Commissioner*, 120 F. (2d) 564 (C. C. A. 7), the court, relying upon *Welch* v. *Helvering*, *supra*, and *Deputy* v. *du Pont*, *supra*, held that an expenditure incurred by an attorney in an effort to expunge an order of suspension from practice before the Treasury Department "was not an ordinary expense" (p. 566). See also *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7), certiorari denied, 284 U. S. 618, denying the deductibility of penalities paid as a result of the violation of the Safety Appliance Act.

The English courts have reached similar results in applying the cognate provisions of the British Income Tax Acts. See *Inland Revenue Commissioners* v. *Von Glehn*, [1920] 2 K. B. 553; *Inland Revenue Commissioners* v. *Warnes & Co.*, [1919] 2 K. B. 444; *Ward & Co.* v. *Commissioners*, [1923] A. C. 145.

tor & Equipment Co. v. *Commissioner*, 35 B. T. A. 189; *New Orleans Tractor Co.* v. *Commissioner*, 35 B. T. A. 218; *Nicholson* v. *Commissioner*, 38 B. T. A. 190.[4] Likewise, this Court has recently refused to sanction the deductibility, as an ordinary and necessary business expense, of lobbying expenditures to procure legislation. *Textile Mills Corp.* v. *Commissioner*, 314 U. S. 326.

The court below refused to follow the *Textile Mills* case apparently on the ground that that decision turned solely upon the existence of a Treasury Regulation which provided that "Sums of money expended for lobbying purposes * * * are not deductible from gross income," and that to deny the deductibility of the expenditures involved in the instant case as ordinary and necessary business expenses, would require the court "to amend the statute." The court did not express

[4] The two cases on which the court below relied for its contrary decision did not go so far as the court evidently thought. *Foss* v. *Commissioner*, 75 F. (2d) 326 (C. C. A. 1), did not involve expenditures in a suit resisting public disciplinary action, and there is no evidence in the opinion that the court gave attention to and rejected the considerations advanced herein. *Alexandria Gravel Co.* v. *Commissioner*, 95 F. (2d) 615 (C. C. A. 5), did not involve expenditures which could be regarded as against public policy since the court held that there was no evidence that they were made to purchase political influence. The court did, however, utter the dictum on which the court below relied. See objections to that dictum in the concurring opinion of Judge Clark in *Textile Mills S. Corp.* v. *Commissioner*, 117 F. (2d) 62, 72 (C. C. A. 3), aff'd 314 U. S. 326.

the view, as indeed it could not reasonably have done, that a greater degree of proximate cause linking the activities and the expenditures existed in this case than in the *Textile Mills* case. The court erred in viewing the Textile Mills regulation as the exclusive application of the considerations of public policy on which it rested. The regulation was illustrative only, and in the nature of things it could not be more since the Commissioner cannot, any more than Congress could, hope to promulgate a regulation to fit precisely each of the circumstances of life encountered by the tax laws. These same considerations of public policy also underlie the provision in Art. 23 (a)–1 of the Regulations (Appendix, *infra*, pp. 23–24) disallowing deduction of penalty payments with respect to Federal taxes. Clearly the Commissioner's recognition of public policy is not confined to those instances where he has issued a general regulation precisely in point. Cf. *Gray* v. *Powell*, 314 U. S. 402, 412; *Gregory* v. *Helvering*, 293 U. S. 465; *Helvering* v. *Clifford*, 309 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473. Thus the *Textile Mills* decision necessarily recognizes that considerations of public policy are properly taken into account in construing the statute herein involved, and it seems hardly open to debate that not only the administrator but the courts as well are expected to apply a construction to the statute which is consistent with public policy. While the statute

makes no express reference to considerations of public policy, "like all language it has to be interpreted in the light of the tacit assumptions upon which it is reasonable to suppose that the language was used" (Mr. Justice Holmes in *Popovici* v. *Agler*, 280 U. S. 379, 383). It has been uniformly interpreted by the courts and the administrator, as the previously cited decisions show (see also G. C. M. 23438, 1942–2 Cum. Bull. 188; O. D. 952, 4 Cum. Bull. 209 (1921); S. R. 3137, IV–1 Cum. Bull. 170 (1925); G. C. M. 11358, XII–1 Cum. Bull. 29 (1933); S. R. 1448, IV–1 Cum. Bull. 140 (1925); I. T. 1174, I–1 Cum. Bull. 269 (1922)), as not intending, for reasons of public policy found to be implicit in its language, to authorize deductions for expenditures occasioned solely by the taxpayer's illegal conduct. This long-standing construction is entitled to great weight, particularly so in view of the successive reenactment by Congress of the statute employing the phrase "ordinary and necessary." Cf. *Brewster* v. *Gage*, 280 U. S. 327; *Textile Mills Corp.* v. *Commissioner*, *supra*; see also *Morgan* v. *Commissioner*, 309 U. S. 78, 81; *Helvering* v. *Winmill*, 305 U. S. 79, 83.

Therefore, while this Court in *Textile Mills Corp.* v. *Commissioner*, *supra*, declared that the rule-making authority might employ the general policy against lobbying activities in its segregation of non-deductible expenses, the fact that in the in-

stant case, unlike the *Textile Mills* case, there is no regulation can not be controlling. Policy considerations such as were present in the *Textile Mills* case are even more clearly present here. Unlike the *Textile Mills* case, we have here an Act of Congress expressly condemning the very activities engaged in by the taxpayer and out of which the expenditures in question grew, and an authoritative determination by the competent authorities that the taxpayer's activities were in violation of that Act. The purpose of the federal statute under which the fraud order against taxpayer was issued and enforced is to prevent the use of the mails as a medium for disseminating printed matter which, on grounds of public policy, has been declared to be non-mailable. *Farley* v. *Heininger,* 105 F. (2d) 79, 84 (App. D. C.), certiorari denied, 308 U. S. 587. The taxpayer, by engaging in those activities condemned by the statute, deliberately violated the established policy of the Government for the protection of the public, and the expenditures involved were incurred in an effort to be allowed to continue the unlawful practices. Clearly such expenditures are not deductible.

The court below interpreted the Government's position as meaning that illegal businesses would be taxable on their gross income. However, the Government's position herein is no more susceptible to this interpretation than the decision of this Court in *Textile Mills Corp.* v. *Commissioner,*

supra, in which lobbying expenses of a lobbying corporation were held nondeductible. Neither the *Textile Mills* case nor the Government's position herein would prevent the respective taxpayers from deducting expenses such as office rent, cost of dental materials, and the like. The vice in the expenses here sought to be deducted as ordinary and necessary is that they were incurred in an unsuccessful attempt to avoid the lawful curb which the Government was seeking to place on unlawful features of the taxpayer's business conduct. To allow the deduction would be to allow compensation for the costs which law enforcement has caused the one who has transgressed, which plainly Congress did not intend. Cf. *Clarke* v. *Haberle Brewing Co.,* 280 U. S. 384.

In any event, the Commissioner has not taken the extreme position which the court below has attributed to him, and this case does not require him to do so. Here the business was not unlawful, though some of the practices were. But the lawful business could be separated from the unlawful practices. Hence this case does not compel consideration of the treatment to be accorded expenses of a business which itself is illegal and, as this Court has often said (*United States* v. *Sullivan,* 274 U. S. 259; *Old Colony Tr. Co.* v. *Commissioner,* 279 U. S. 716, 731), it will be time enough to consider how far the Government's theory may reach when an attempt is made to extend it beyond the situation here presented. Taxation is a prac-

tical matter and there is no occasion to push the argument to "a drily logical extreme." Cf. *I. C. C.* v. *New York, N. H. & H. R. Co.*, 287 U. S. 178, 192.

We know of no instance heretofore where expenditures incurred as the result of unsuccessfully resisting disciplinary measures instituted by the sovereign have been permitted by the courts to be deducted as ordinary and necessary business expenses.[5] We think it clear that the "way of life" envisaged by Congress in enacting Section 23 (a) contemplates no encouragement through that section of those activities which, as in the instant case, constitute public offenses.

CONCLUSION

The decision of the Circuit Court of Appeals is incorrect and should be reversed.

Respectfully submitted.

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SEPTEMBER, 1943.

[5] As pointed out in footnote 4, *supra*, p. 16, the two cases relied on below do not so hold and did not involve the point.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
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> * * * * *

Section 23 (a) of the Revenue Act of 1938, c. 289, 52 Stat. 447, is identical with Section 23 (a) of the Revenue Act of 1936, *supra*.

Revised Statutes:

> SEC. 3929, as amended.—The Postmaster General may, upon evidence satisfactory to him that any person or company is engaged in conducting any lottery, gift enterprise, or scheme for the distribution of money, or of any real or personal property by lot, chance, or drawing of any kind, or that any person

or company is conducting any other scheme or device for obtaining money or property of any kind through the mails by means of false or fraudulent pretenses, representations, or promises, instruct postmasters at any post office at which registered letters or any other letters or mail matter arrive directed to any such person or company, or to the agent or representative of any such person or company, whether such agent or representative is acting as an individual or as a firm, bank, corporation, or association of any kind, to return all such mail matter to the postmaster at the office at which it was originally mailed, with the word "Fraudulent" plainly written or stamped upon the outside thereof; and all such mail matter so returned to such postmasters shall be by them returned to the writers thereof, under such regulations as the Postmaster General may prescribe. Nothing contained in this section shall be so construed as to authorize any postmaster or other person to open any letter not addressed to himself. The public advertisement by such person or company so conducting such lottery, gift enterprise, scheme, or device, that remittances for the same may be made by mail to any other person, firm, bank, corporation, or association named therein shall be held to be prima facie evidence of the existence of said agency by all the parties named therein; but the Postmaster General shall not be precluded from ascertaining the existence of such agency in any other legal way satisfactory to himself. (U. S. C., title 39, Sec. 259.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (a)–1. *Business expenses.*—Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, * * *. Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see article 23 (a)–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is nevertheless deductible, even though such expenses exceed the gross income derived during the taxable year from such business. As to items not deductible under any provision of section 23, see section 24.

Article 23 (a)–1 of Treasury Regulations 101, promulgated under the Revenue Act of 1938, is identical with Article 23 (a)–1 of Treasury Regulations 94, *supra*.

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IN THE

Supreme Court of the United States

OCTOBER TERM, A. D. 1942

No. 1027

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

S. B. HEININGER,
Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI.

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To the Honorable, the Chief Justice and Associate Justices of the Supreme Court of the United States:

The petitioner has made a sufficient statement of the case.

Reasons for Denial of the Writ.

1. The decision herein of the Seventh Circuit Court of Appeals is manifestly correct and sound.

2. The cases relied upon by the petitioner are clearly distinguishable from the instant case and are not in conflict therewith.

3. The decision below is sustained by the controlling decisions of this Court (*Kornhauser* v. *United States*, 276 U. S. 145-153, 48 S. Ct. 219, and *Welch* v. *Helvering*, 290 U. S. 111, 114, 54 S. Ct. 8, 9); and the decision is supported by *Foss* v. *Commissioner*, 75 F. (2d) 326, (First Circuit), and *Alexander Gravel Co.* v. *Commissioner*, 95 Fed. (2d) 615, 616 (Sixth Circuit).

ARGUMENT.

This petition for a Writ of Certiorari involves the single question whether expenses incurred for attorneys' fees expended in legal proceedings which threaten the life of a business and which, for a time, saved the life of that business and, therefore, made possible the production of taxable income, are deductible as ordinary and necessary business expense within the meaning of Section 23 (a) (1), 26 U. S. C. A., Int. Rev. Code, 49 Stat. 1648.

In the defense of his business the taxpayer incurred and paid attorneys' fees and expenses beginning in about September 1937 (R. 17) in resisting the issuance of a so-called "Fraud Order". These expenditures made it possible for the petitioner to produce the income which was earned by him during the remainder of that year. Thereafter, upon the issuance of such "Fraud Order" in February, 1938, the taxpayer employed attorneys and filed a bill of complaint for injunction in the District Court for the District of Columbia to restrain the execution of the aforesaid "Fraud Order" (R. 18). In June 1938 the taxpayer was granted a permanent injunction against the Postmaster General restraining the execution of the "Fraud Order" (R. 18). The respondent would have had no business income in the year 1938 had he not made the expenditures in question. The Postmaster General appealed from this injunction decree and in April 1939 the United States Court of Appeals reversed the decree of the District Court and ordered the injunction dissolved. Subsequent thereto this Court denied a petition for a Writ of Certiorari (R. 18).

The question now is, are the attorney's fees and legal expenses, so incurred "ordinary" and "necessary" and therefore deductible as business expense. In *Welch* v. *Helvering*, 290 U. S. 111, a taxpayer sought to deduct as business expense payments made by him on the debts of a corporation of which he was a former officer. The payments were made after the corporation's discharge in bankruptcy and for the purpose of strengthening the taxpayer's business standing. In considering whether such payments were "ordinary" in the statutory sense, this Court at page 114 said:

> "Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser* v. *United States*, 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type."

In the case of *Kornhauser* v. *United States*, 276 U. S. 145, a taxpayer sued to recover an additional income tax payment made by reason of the refusal of the Commissioner of Internal Revenue to allow a deduction from his gross income of a payment of attorney's fees. The fees had been incurred in the defense of an accounting suit instituted by his former co-partner. This Court held that

the payment of attorneys' fees was an ordinary and necessary business expense and at page 153 said:

> "The basis of these holdings seems to be that where a suit or action against a taxpayer is directly connected with, or, as otherwise stated (*Appeal of Backer*, 1 B.T.A. 214, 216), proximately resulted from, his business, the expense incurred is a business expense within the meaning of Sec. 214 (a), subd. (1), of the act. These rulings seem to us to be sound and the principle upon which they rest covers the present case. If the expense had been incurred in an action to recover a fee from a client who refused to pay it, the character of the expenditure as a business expense would not be doubted. In the application of the act we are unable to perceive any real distinction between an expenditure for attorney's fees made to secure payment of the earnings of the business and a like expenditure to retain such earnings after their receipt. One is as directly connected with the business as the other."

That the decision of the Circuit Court of Appeals herein is manifestly sound and correct is apparent when examined in the light of the controlling authorities above cited. The life of the taxpayer's business was threatened; in these circumstances he pursued the "ordinary" and normal course of conduct and proceeded to a "defense against attack". Certainly expenses so incurred were likewise "necessary" because they were "directly connected with" and "proximately resulted from," his business. As stated by the Court of Appeals in its decision (R. 49):

> "Without this expense, there would have been no business. Without the business there would have been no income. Without the income, there would have been no tax. To say that this expense is not ordinary and necessary is to say that that which gives life is not ordinary and necessary."

Cases Cited by Petitioner Distinguished.

The case of *National Outdoor Advertising Bureau* v. *Helvering*, 89 Fed. (2) 878, as well as the other authorities relied upon by the petitioner plainly show that the deductions claimed were disallowed because the taxpayer had been adjudicated guilty of illegal conduct or had admitted guilt by consent decree or otherwise. None of these factors were involved in the legal proceedings which were the subject of the attorneys' fees claimed as deductions in the instant case. The respondent proceeded to defend his business against attack, in the commonly recognized manner by the employment of attorneys and sought and obtained relief in the Courts.

Other cases cited by petitioner likewise concern deductions of a wholly different character than those involved in the instant case. As in *Burroughs Bldg. Material Co.* v. *Commissioner*, 47 Fed. (2) 178, where the taxpayer and its president had pleaded guilty and was fined and the attempted deductions included both the fines and the legal expense; *Helvering* v. *Superior Wines and Liquors, Inc.*, 134 Fed. (2) 373, where the deduction claimed had been paid as a compromise of a violation of a statute regulating the traffic in intoxicating liquors and attorneys' fees in connection therewith; *Textile Mills Securities Corp.* v. *Commissioner*, 314 U. S. 326, where the expenses sought to be deducted included "lobbying" expenses which were clearly prohibited by the Treasury Regulations; *United States* v. *Jaffray*, 97 Fed. (2) 488, which concerned negligence penalties imposed under the income tax laws; *Great Northern Ry. Co.* v. *Commissioner*, 40 Fed. (2) 372, which denied the deduction of a sum paid for fines arising from a statutory violation. *McDuffie* v. *United States*, 19 Fed. Supp. 239 (C. Cls.), and *Standard Oil Co.* v. *Commissioner*,

129 Fed. (2) 363, involved deductions of sums paid upon judgments and expenses for a fraud committed against the government. *Maddas* v. *Commission*, 114 Fed. (2) 548, concerns bribes paid to prohibition agents.

CONCLUSION.

The reasons assigned in the opinion of the Circuit Court of Appeals (R. 46-49) are sound and well supported by the decisions of this Court and of other Circuit Courts of Appeal (br. p. 2). We urge that the Petition for a Writ of Certiorari be denied.

Respectfully submitted,

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